

FIELD REPORT

**PRIVATE SECTOR DEVELOPMENT OF HOUSING
EASTERN EUROPE**

Report and Recommendation for an Independent Regulatory Commission

Prepared for

**United States Agency for International Development
Bureau for Europe and the Newly Independent States
Office of Energy, Environment and Urban Development
Urban Development and Housing Division
Washington, DC**

Prepared by

**Mr. Jerome Donovan
Mr. Michael McLindon
The Institute for Public Private Partnerships**

**PADCO, Inc.
1025 Thomas Jefferson St., NW
Suite 170
Washington, DC 20007**

**Contract No. EUR-0034-00-C-2032-00, RFS 67
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Table of Contents

Executive Summary	1
I. Background	2
A. Public Utilities and the Mass Privatization Program (the Program)	2
B. Significant Developments in Privatization and Current Trends	3
II. Important Considerations in Selecting a National Regulatory Framework ..	5
A. Overview	5
B. Specific Issues	6
III. Recommendations for an Independent Regulatory Commission	9
A. Duties of the IRC	11
B. Powers of the IRC	11
C. Granting of Licenses	12
D. Tariffs	12
E. Financing the IRC	12
F. Constitution and Composition of the Commission	13
IV. Recommendation for Interim Action if an IRC Is Not Accepted	13
A. The “Ministerial Model”	13
B. The First Cell(s) as Prototype for an IRC	13

Appendices

Appendix A Persons Contacted in Tirana, April 11-21, 1995

Executive Summary

The Government of Albania's (GOA) privatization plans for utilities (power, telecommunications, water/wastewater, some transportation) are not finalized, but they appear to point to privatized, investor-owned utilities — especially for power and telecommunications — over the next several years. We recommend the development of an independent regulatory commission (IRC) to regulate these privatized utilities. This would help establish fair, economic prices, and eliminate “political pricing,” which invariably undermines the efficient delivery of utility services. The goal would be to establish a level playing field for consumers and investors — one which would protect their mutual interests. This would also promote professionalism within the IRC and the development of necessary regulatory activities in other economic areas (e.g., securities markets).

Were the GOA, for whatever reason, to decide that the early establishment of an IRC was not feasible, then we would recommend that it immediately announce its intention to establish an IRC within a reasonably short timeframe (e.g., two years), but concentrate first on building a basic regulatory capacity within each relevant ministry, recognizing that there is not an abundance of experienced staff available in Albania. (See the “ministerial model” described at II.B.3 on page 8.)

The IRC should be designed to be flexible and modestly staffed and to have capacity to regulate utilities as they are privatized. For example, if power is the first utility to be privatized, the IRC would first establish a power unit to perform the regulatory functions. As other utility sectors are privatized, the IRC would create additional units to regulate them as well.

Several ministries, such as the Ministry of Energy, have developed in-house regulatory capacity. This is not necessarily inconsistent with the establishment of an IRC, because such in-house capacity could help a ministry highlight key policy and pricing issues. However, it should be clear that the actual regulatory functions of all privatized utilities will eventually be transferred to the IRC.

The IRC will initially require donor assistance to obtain financing and technical assistance, and possibly GOA assistance as well. In the medium term, the IRC should become self-financing through fees for licenses and general charges on private sector utility firms.

It is important that donor assistance be coordinated to support this concept. Otherwise, individual projects may inadvertently promote the development of regulatory functions within ministries, which, as noted above, could undermine the concept and role of the IRC and the principle of independent regulation.

It is also important to secure the support of the World Bank for this approach to the IRC. Its support at the policy-dialogue level, and in coordinating donor activities, will

be very important. During our two-week mission to Albania, discussions with leading World Bank officials have been very encouraging. This dialogue should continue to remain a top priority.

Report and Recommendation

I. Background

A. Public Utilities and the Mass Privatization Program (the Program)

While to date (April 22, 1995) no mass privatization law as such has been passed by the Albanian People's Assembly, there is legislation (Law 7512) authorizing it.¹ Law 7512 provides, *inter alia*, that:

“All sectors of the economy, including state-owned enterprises, institutions, and other entities [may be] privatized and ... conduct private activity. The conversion to private property shall be in all fields of productive activity — industrial, handicraft, agricultural, construction, transportation, banking services, internal and external trade, communal and artistic activities, advocacy, charitable services and foundations, and other possible fields.

“State enterprises or other entities in branches of special importance to the economy — **energy and mining, oil and gas, post and telecommunications, forestry and water resources, roads and railroads, seaports, airports, and air and rail transport** — may be privatized in specific cases in accordance with law”² (emphasis added).

Confirming the GOA's intention to institute the Program, the People's Assembly recently authorized the distribution of privatization vouchers.³

In addition, a “corporatization” law⁴ is expected to be enacted soon. However, should the draft law pass in its present form, additional legislation will be required

¹ Law on the Sanctions and Protection of Private Property, Free Initiative, Independent Private Activities, and Privatization (Law No. 7512, Aug. 10, 1991, promulgated by Presidential Decree No. 22, Aug. 15, 1991) (unofficial translation from Albanian).

² *Ibid*, Art. 3.

³ *Albanian Daily News*, April 19, 1995.

⁴ Law on the Transformation of State-Owned Enterprises into Commercial Companies (draft) (unofficial translation from Albanian).

corporatize public utilities.⁵ Such additional legislation is expected to be passed over time on a utility-by-utility basis.

Other legislative activity suggests the GOA's determination to involve the private sector in the provision of essential services. These include a concession law (whose passage appears imminent) and separate laws on water resources, power, and telecommunications, each of which provides for roles for the private sector.

There appears to be a consensus among Albanian officials that power will be addressed first, followed by water, with perhaps telecommunications third. The broad scope of the task is indicated by the economic activities encompassed by the public utilities, to wit:

- **Power** (generation, transmission, distribution)
- **Water** (supply, operation, treatment, distribution)
- **Telecommunications** (conventional, mobile, radio, cellular, telex, paging systems, data processing; and broadcast, cable, and satellite transmission of television, radio, voice, and data)
- **Transport** (highways, bridges, tunnels, railroads, canals, seaport, airports)
- **Solid and hazardous waste** (collection, management, transport, treatment, disposal)
- **Other** (industrial estates, parks, export-processing zones, free-trade zones)

B. Significant Developments in Privatization and Current Trends

During 1994, more than 2,400 small and medium enterprises were privatized. In 1995, an estimated 1,500 additional small and medium enterprises will be privatized. Together, this privatization effort will represent 95 percent of small and medium enterprises.⁶

The privatization of large-scale enterprises is scheduled to get underway in 1995 through the Program with (tradable) vouchers. Entities to be privatized may include large industries, mines, tourism, and possibly the banking system.

The GOA has not finalized its plans to privatize utilities, such as power, water, and telecommunications. During our discussions with various officials and ministries working in these divisions, it appeared that combinations of concessions/BOT approaches, on the one hand, and corporatization and inclusion in the Program, on the other, were under consideration.

⁵ Art. 10 of the draft law specifically excludes the public utilities mentioned in Art. 3, Law 7512, note 2, above.

⁶ "Focusing Reform," *Albanian Observer*, No. 2, 1995, p. 15.

For power, the current plan apparently is to separate (“unbundle”) KESH’s generation, transmission, and distribution functions. Current generation facilities would be corporatized and privatized. The shares of the corporatized entities could possibly be eligible for inclusion in the Program. Additional private sector companies would be granted the right to supply the grid with electricity.

Transmission activities would be incorporated into a separate company, with the GOA retaining ownership of the shares for the next few years. Distribution activities would be divided into one or more corporatized companies, which would be privatized, possibly as a part of the Program. Foreign firms would be encouraged to acquire partial ownership in these distribution companies in exchange for capital injections, new technology, and management skills.

In the water sector, some Government officials have indicated a preference for a concession approach to the privatization of water (and wastewater) systems. They appear to favor a pilot effort in a small city, followed by larger-scale efforts in Tirana and Durres, for completion in 1996. However, there is concern in some quarters that a privatization approach that does not address the key issues of Albania’s relative paucity of administrative talent and the GOA’s inability to systematically reduce system loss and improve on collection rates will not significantly improve the current unsatisfactory state of water delivery.

For this and other reasons, including the desirability of including the maximum possible number of attractive assets in the Program, the various water systems have also been mentioned as possibilities for the Program, following corporatization. This would result in their full ownership by the private sector.

The experience of other countries has demonstrated that, in general, full privatization yields significant gains in economic and technical efficiency and benefits to consumers. For these benefits and gains to be fully realized, though, an appropriate regulatory structure must be in place.

In the telecommunications sector, the current plan is to attract a strategic foreign partner who would own a significant but minority position in the telephone company. This strategic partner would be selected through a competitive international tender. The remaining shares (51 percent or more) would then be distributed to Albanian citizens, most probably through the Program. This newly privatized company would then have a monopoly on local and international telephone calls for a period of about eight (8) years to encourage new investment (Albania’s telephone penetration is one of the lowest in Eastern Europe), after which the sector would be opened up to competition.

In these three key utilities, therefore, the GOA has yet to finalize its privatization plans. Based upon our discussions, it seems clear that, on balance, the present

objective is to try to move toward full privatization, at least over the next several years.

This implies that these utilities will essentially become investor-owned, underscoring the need for an independent regulatory commission that has significant powers to set rates and standards of service to balance the needs of consumers and investors.

II. Important Considerations in Selecting a National Regulatory Framework⁷

A. Overview

The regulation of public utilities must both (a) support efficient production and use of services; and (b) encourage investment in the utilities. Fair and effective regulation results from rules that permit investors to make a profit; this, in turn, encourages production, once the potential investor has acquired enough confidence in the stability and transparency of the country's commercial environment. Because it promotes competition and market-based pricing, such regulation also encourages efficiency.

There are three essential types of regulation:

- **Structural regulation.** An industry's structure is determined by: the number of entities allowed to operate; their vertical and horizontal integration; provisions for competition or exclusivity; obligations to provide service; and rules for entry and exit. When a government chooses the structure of the industry, often through the privatization process, it also takes a large step toward determining the appropriate regulatory scheme; a scheme that is appropriate for one industrial sector (e.g., power) might not be appropriate for another (e.g., ports).
- **Conduct regulation.** Conduct regulation is the review and control of a regulated company's operations and investment decisions. The review of a company's conduct can occur either before the company signs key contracts, for example, or afterwards, when the company seeks to recover past expenses by charging consumers (the end users) higher future prices. Company regulation is widely thought to be too cumbersome, inflexible, and intrusive for general applicability, especially in countries like Albania, that have no recent tradition of market-based regulation.
- **Performance regulation.** Performance regulation is based on the regulator — a ministry, an individual, or an independent commission — establishing one or more targets for firms. Typical targets are the return-on-equity ("rate-of-return") model, which is widely used in the United States, and the price-cap method, which is widely used in the United Kingdom. (A common price-cap formula is

⁷ This section draws on and adapts World Bank material from *Outreach # 14* (Nov. 1993) and a staff recommendation of a regulatory framework for an Asian country (April 21, 1994).

RPI-X, in which the Retail Price Index is reduced by an X-factor comprised of elements like anticipated increased productivity, demand, and capital costs.)

When the GOA privatizes its public utilities, it will thereby be imposing structures on them. It will then have to choose the best method(s) to regulate the enterprises within the privatized utilities. Choosing the best method can be a complex process. Countries with strong, independent judicial and legal systems with records of competent performance by independent regulators are free to choose options that may not be appropriate for countries whose legal and judicial institutions are new and untried.

The United States and United Kingdom may rely on rather complex systems of regulatory rules; relevant checks and balances are in place, and decentralized decision-making can support the independent regulator and minimize the chances for inappropriate decisions. In the U.K., for example, the implementation of the RPI-X formula is possible only because of the country's long history of effective regulatory institutions and the reliable economic information they customarily provide.

Countries with new or less developed regulatory histories and institutions are best advised to select simpler regulatory structures, based on flexible rules. However, if such a country decided to try the RPI-X system, for example, it might restrict its application to noncompetitive areas, but with a fixed X-factor. This might work well in regulated sectors like water and ports. However, where the sector is one in which there is rapid and unpredictable technological development, such as telecommunications, to fix the X-factor would risk an overestimation (or underestimation) of costs and profits, and this, in turn, could lead to public pressure to renegotiate regulatory terms and conditions, leading to an unsustainable regulatory system in the long run.

Countries new to regulation and having new and untested judicial, legal, and regulatory institutions can take several steps to enhance the chances of successful regulation of utilities.

- Assure that in the privatization process shares of the utilities are widely distributed among the population. This will create a constituency for the utility that will act as a brake on arbitrary government action against the utilities.
- Undertake a sequenced program of privatization, such as that contemplated by the GOA. This sequencing could include the privatization of individual utilities in *tranches*, such as the Ministry of Energy is contemplating with privatization of distribution before other elements (production and transmission) of the sector. In this way, privatization of the later elements can be made contingent on the effective regulation of the earlier privatized elements.
- Continue efforts to reform and strengthen judicial, legal, and other core Government institutions.

B. Specific Issues

As the GOA reviews the various regulatory options for the sectors it wishes to regulate, it should have clear objectives in mind. The GOA should be able to defend its regulatory policies to skeptics in the Government, the opposition, and among the people themselves. Therefore, as a form of checklist of issues, it is useful here to raise some of the most frequently asked questions about regulation and suggest some persuasive answers.⁸

1. What do regulators do?

- Provide assurance to the GOA that its policies regarding regulation will be carried out.
- Provide assurance to private investors that their legitimate business interests will be protected.
- Provide assurance to consumers (end users) that their interests will be protected; that is, that they will receive dependable and efficient service from the regulated utility at a fair and reasonable price.
- Provide assurance to all parties with interests in the utility (GOA, private investors, and consumers) that sufficient skills, expertise, and resources will be applied in a way to ensure confidence in the regulatory system and regulatory result.

2. What are the basic elements of a good regulatory system?

- It must have clearly defined legal authority on which sectors are to be regulated and how they are to be regulated.
- It must have well established methods of ensuring that the regulator is accountable to the public and the government in the exercise of its authority.
- It must have adequate funding and financial support.
- It must have properly selected and trained personnel.

3. What are the basic models for regulation?

- The **ministerial model**, in which the regulation is performed by a person or group within the ministry that has jurisdiction over the regulated sector (e.g., telecommunications would be regulated by the Ministry of Industry, Transport, and Commerce).
- The **independent regulator model**, either an individual or a commission (the latter of which is recommended for Albania).
- Regulation on the **local or national level**.

⁸ This section draws on materials prepared by John Conway, Esq., of the U.S. Federal Energy Regulatory Commission.

4. What values or attributes underlie an effective regulatory system?

- **Fair process**, characterized by known standards, an objective approach to the process, and information fairly obtained.
- **Consistency and predictability**. That is, the regulator will handle similar issues in similar ways.
- **Flexibility**. That is, the regulator will not insist on a rigid consistency where special circumstances indicate some other solution makes more sense.
- **Nondiscriminatory action**. That is, the regulator will treat all concerned parties equally.
- **Established procedural rules**.
- **Opportunity for all interested parties to be heard**.
- **Written decisions** with explanations and standards.

5. What is an independent regulator?

- Appointments based on professional qualifications and expertise.
- Tenure (job security) guaranteed for good behavior.
- Restrictions to bar conflicts of interest.
- Adequate funding.
- Other measures of autonomy.

6. How does the government ensure the accountability of the independent regulator (i.e., how does it “regulate the regulator”)?

- Duties must be specified and limited by law or custom.
- Decision-making must be “transparent” (i.e., as open to the public as possible).
- Decisions and actions must be subject to review by the executive branch of the government, the People’s Assembly (e.g., oversight and budget committees), the press, and auditors.
- Laws and traditions protecting employees.

7. What are the standards for ethical conduct?

- Accept no gifts from persons with matters pending before the regulator or likely to come before him for decision.
- Have no conflicting financial interests that might cast doubt on the fairness of the regulator’s decisions.
- Seek no other employment while acting as regulator.
- Do not abuse or misuse the position of regulator.
- Restrict inappropriate outside activities, including political activities.

- Have rules governing post-regulatory employment with persons or companies who had matters before the regulator while he held the position of regulator.

8. What are the attributes of an independent individual, as opposed to an independent commission, as regulator?

- Direct accountability for decisions.
- Potential for individual personality to dominate.
- Potential for delays in decision-making.
- Potential for corruption or improper influence.
- Predictability of decisions.
- Potential for continuity.
- Potential of being “captured” by politics or the entities being regulated.

9. What are the attributes of an independent commission, as opposed to an independent individual, as regulator?

- Potential for economies of scale in administration.
- Potential for representing multiple professional skills and experiences.
- Resistance to improper influence from regulated entities or politics.
- Opportunities to promote consistent policy approaches.
- Opportunities to promote cross-fertilization of relevant experience.

III. Recommendations for an Independent Regulatory Commission

As discussed above, the current plans of the GOA call for the introduction of the private sector into the energy and water sectors, although the method and extent of privatization is still under discussion.

We recommend an independent, self-financing regulatory body for privatized utilities for Albania. This body, called the Independent Regulatory Commission (IRC), should be set up to provide the required regulatory framework as the privatization of these sectors begins to unfold.

Our principal reasons for this recommendation are implied by the attributes of the independent individual regulator (see above). While such regulators have the virtue of being directly accountable for their decisions and the presumed virtue of issuing predictable decisions, we believe that these virtues are outweighed by the negative elements. For example, independent individual regulators can quickly become “czars” whose decisions might well be affected — or be perceived by the public to be affected — by improper influence and corruption. No other regulators exist to act as a check on such behavior. A corollary to the foregoing is the possibility that an independent individual regulator might become too closely associated with the

entities he is supposed to be regulating — that he becomes “captured” by them, resulting in ineffective regulation at the best, and outright fraud at the worst.

While the negative attributes of the independent individual regulator are serious considerations, such considerations attach with even greater tenacity to the individual regulator who, in fact, is not independent. Where individual regulators (or regulatory bodies [“commissions”]) are placed within ministries, the likelihood of having even-handed, transparent, and economically based regulation diminishes even more. By their very nature, in-house regulators are more exposed than independent regulators to special pleading and undue influence, and non-economic (“political”) factors are much more likely to be taken into account in decision-making than would be the case with independent regulator.

It should be noted that the exact duties and responsibilities of the IRC will depend on the form of privatization that is chosen for each regulated sector. For example, if the GOA should initially choose to use a concession approach to privatize the water sector, this will have different implications for the regulatory duties of the IRC than if the water sector is made a part of the Program, and the various water companies essentially become investor-owned utilities. A concession agreement between a private sector entity and the state-owned utility generally contains many of the provisions that would typically be found in a license granted by a regulatory body, and regulatory requirements would be fairly minimal. On the other hand, a fully privately owned utility would require more independent regulation to ensure that the respective interests of consumers and investors were mutually respected.

Therefore, this section sets out the form of the IRC in general terms, with the flexibility to deal with partially privatized utility sectors. At the same time, it assumes that ultimately the GOA will move to full privatization of these utilities over the next few years. The experience of other countries has demonstrated that full privatization yields significant economic benefits and gains in efficiency. For these benefits and gains to be fully realized, though, an appropriate regulatory structure must be in place.

As additional sectors (such as telecommunications) are fully or partially privatized, the regulatory responsibilities for them can be also assigned to the IRC.

A single body to regulate the utilities would have several advantages. First, it would achieve certain economies of scale, and therefore be cost-effective, because basic operational services would only have to be provided by one institution. Qualified staff are a scarce resource, and it would be advantageous to have them located in one institution rather than dispersed among several institutions. Second, assigning responsibilities for the regulation of all the utilities could strengthen the IRC’s position and independence. This is important so that the pricing for utility services can be based more closely on economic criteria, rather than on political or other criteria. This, in turn, will help place the utilities on financially sound footing, since

the interests of both consumers and investors would be addressed. Finally, placing regulatory responsibilities for utilities under one roof will make it easier to attract technical assistance and support from the donor community, which will be necessary during the first few years of operation to ensure the IRC's long-run viability.

Donor coordination will be critical to setting up an independent regulatory entity. Uncoordinated donor projects with various line ministries may inadvertently assign important regulatory functions to ministries, which would undermine efforts to concentrate regulatory oversight in one entity, as well as to establish an independent regulatory capability. Instead, it is important that donors agree to support the establishment of an independent regulatory body, and to provide financial support, including technical assistance, during the start-up phase.

A. Duties of the IRC⁹

The general duties of the IRC would be to:

- promote technical and economic efficiency on the part of those private sector firms granted licenses by the IRC;
- promote the efficient and safe use of utility services;
- enable licensees to earn a reasonable rate of return, provide for needed maintenance and new investment, and be rewarded for overall cost reductions, while maintaining and improving levels of service;
- enable reasonable demands for utility services to be met;
- protect the interests of the consumers of utility services in terms of:
 - prices, charges, and other terms of service; and
 - quality, efficiency, and reliability of service;
- promote unbundling of, and vigorous competition in the provision of, utility services;
- enable third parties to connect to the basic systems of utility services, such as power (transmission and distribution), water (mains), telecommunications (local and long- distance networks), and other utility services where practicable, on a non-discriminatory basis and on terms and conditions that are fair and reasonable;
- achieve transparency in the activities of the utilities sector and the IRC; and
- achieve a fair balance of the consumers, the Government, the public, investors, and participants in utility services.

⁹ This section draws on and adapts World Bank material on a recommended legal and regulatory framework for the power sector.

B. Powers of the IRC

The IRC will be an independent body, not a part of any other government body, Ministry, or Parliament. This will help ensure independence in its decisions, which, in turn, will help promote pricing for utility services on an economic — rather than political — basis.

The IRC will have the exclusive power to draft its own rules and procedures for the conduct of its business to ensure the fair and efficient regulation of utilities. All such rules and procedures should be published and made publicly available. The IRC should have full powers to recruit and determine the duties of the service of officers and employees.

The IRC should have all the powers that are necessary to obtain information, so that it is able to carry out its functions and duties.

The IRC would be empowered to:

- license utility companies;
- approve rates or charges and terms of conditions of utility services where appropriate;
- develop and enforce performance standards for utility companies;
- encourage uniform industry standards and codes of conduct; and
- prepare industry reports for submission to the GOA and gather relevant information from utility service companies to:
 - ▶ prescribe fees applicable to licensees;
 - ▶ impose sanctions for violations;
 - ▶ frame regulations to give effect to the powers conferred and functions required of the IRC; and
 - ▶ perform any other functions that are incidental or consequential to any of the above functions.

C. Granting of Licenses

Only those persons authorized by license or exemption to provide utility services by the IRC may provide those services. The IRC will determine which utility service activities are to be licensed. For example, it may not be necessary to license electricity generation, since competitively bid power purchase agreements may contain all of the terms and conditions that would otherwise be found in a license. It could also determine that sufficient competition exists in certain subsectors of utility industries and that regulation is not required.

Licenses to utility companies should be issued for the limited purpose of promoting the safe, reliable, and economic operation of utility services and should state:

- the type of service to which the license applies;
- the location of the facilities of the utility company;

- the duration of the license, subject to revocation under the law governing the IRC and in accordance with the terms and conditions of the license; and
- all applicable license conditions.

D. Tariffs

The tariffs established by the IRC should:

- protect consumers against monopolistic prices;
- permit licensees to recover their costs of providing service, including the opportunity to earn a return on equity that is sufficient to attract financing for capital improvement and new construction;
- encourage efficiency in internal operations by allowing the licensee's financial return to increase as a result of the licensee having decreased its cost of providing service; and
- encourage economic efficiency within the industry by sending accurate price signals regarding the relative abundance or scarcity of supply.

E. Financing the IRC

The operations of the IRC will eventually be funded by fees prescribed by the IRC for processing various applications, and general fees levied on the companies that it regulates. The initial funding for the IRC will be provided by a GOA grant, which will be repaid over time, and, where possible, by donor assistance.

F. Constitution and Composition of the Commission

The IRC should consist of five (5) members appointed by the GOA from persons selected by a Selection Panel. One of the five members will be designated the chairman of the IRC. The IRC shall make decisions by majority vote. The terms of office for the chairman and the other members should not coincide with the term of office for elected politicians. Members may be removed from office for cause.

IV. Recommendation for Interim Action if an IRC Is Not Accepted

A. The “Ministerial Model”

The GOA might decide that the immediate vesting of an IRC with regulatory authority over all regulated sectors is not feasible. If the GOA so decides, then we recommend that small regulatory offices (“cells”) be established in each ministry housing a regulated sector. These cells should be kept small and priority should be given to the organizing and staffing of cells that will have regulatory responsibilities over sectors that will be privatized first.

Care should be taken that the GOA and the public view the cells as a transitional step only, and that an IRC, the ultimate step, will be taken within a short timeframe (e.g., two years). Therefore, it would be important that the cells resist the normal bureaucratic expansionist tendencies.

B. The First Cell(s) as Prototype for an IRC

Because it is inevitable that the IRC will be affected, for good or ill, by the experience of the cells, it would be crucial that the first cells be staffed by the most competent available people and that the cells' rules of procedure and other professional and ethical practices meet the highest standard.

Appendix A
Persons Contacted in Tirana, April 11-21, 1995

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